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American Institute of Certified Public Accountants (AICPA)

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## HOW TO BUY MALPRACTICE INSURANCE

Although professional liability insurance does not prevent litigation, the purchase of adequate insurance coverage provides practitioners with the peace of mind that comes from knowing that lost billable time will not be compounded by the cost of defending and satisfying a claim.

Many professionals entrust the selection of their firms' malpractice coverage to their insurance broker or agent and their attorney. Because firms' insurance needs are intertwined with those of the owners, however, coverage that meets the distinctive needs of the firm is best obtained with the accountant's involvement.

Professional liability insurance plays a vital role in practice management. By understanding the policy, reviewing the adequacy of coverage, and becoming insurance literate, you can defensively monitor your practice, act more knowledgeably, and effectively defend your interests if a claim is brought. A thorough knowledge of the policy helps you

- ☐ Identify circumstances that could lead to future problems.
- ☐ Respond to notices and communications from the carrier, defense counsel, claimant, and claimant's attorney.
- ☐ Work with your broker, insurer, and attorney to obtain the best coverage for your practice.

Although there is no standard accountants' malpractice insurance policy, commonalities in policy terms, conditions, and exclusions do exist among policies. All aspects of the professional liability insurance policy must be considered in terms of your particular practice needs. A discussion of the issues likely to confront you follows.

### The malpractice insurance policy

A professional liability insurance policy insures you, up to the policy limit, for all covered losses and legal expenses that arise from the performance of professional accounting services that you become legally obligated to pay. The carrier must act in good faith in all of its dealings with the insured. This means investigating and defending you against any covered claim regardless of its merits. The typical professional liability insurance policy describes

- ☐ The scope of coverage.
- ☐ The conditions of and exclusions from coverage.
- ☐ The limits of liability.
- ☐ The insured's duty to cooperate with defense counsel.
- ☐ The insured's duties when a claim is brought.
- ☐ The definition of terms such as *insured*, *professional accounting services*, and *policy period*.

The carrier's responsibility to the accountant, which works to the insured accountant's benefit, is twofold: to defend insureds against all covered claims and to indemnify them for all settlements and judgments up to the policy limit. Generally, the carrier has a more far-reaching obligation to defend the accountant than it does to pay damages.

If the allegations in a complaint are based solely on excluded acts and are therefore not covered, the insurance company has no duty to defend or indemnify the accountant, and the claim will be denied for lack of coverage. The majority of lawsuits allege acts both within and beyond the scope of coverage, however. In these situations, most policies stipulate that the carrier's obligation to indemnify is restricted to covered obligations, and that the duty to defend on all counts exists so long as covered allegations remain at issue in the lawsuit. The carrier's duty to defend terminates when covered allegations are dismissed or otherwise resolved.

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**What's Inside...**

**Policy types**
Accountants' malpractice policies generally fall within two distinct categories.

***Occurrence coverage*** insures accountants against claims as long as a negligent act or omission resulting in a claim occurred during the policy period. The date on which a claim was made is irrelevant to a coverage determination.

***Claims-made coverage*** insures accountants against claims as long as a claim arising from an alleged act, error or omission is made within a policy's effective dates. The date on which an allegedly negligent act was actually committed is irrelevant to a coverage determination so long as it did not occur prior to the policy's retroactive date. As long as such a policy is continuously maintained, protection is provided. If coverage is allowed to lapse—for example, upon an accountant's retirement—the practitioner will have no protection against claims made after the policy's effective date, even if a negligent act or omission occurred within the policy's effective dates.

By purchasing extended "tail" coverage, which extends the period within which claims can be made under the terms and conditions of the policy that has expired, you can maintain protection against claims made after the expiration of the standard policy. Tail coverage generally follows the terms and limits of the standard policy, and its term can extend from one to three years. The most efficient way for a firm to achieve the protection offered by tail coverage is to select a malpractice policy that extends protection to retired partners.

Lapses in coverage resulting from changing policies can be avoided by purchasing prior-acts coverage from the new carrier to insure for negligence that occurred before the new policy's effective dates, or by puchasing tail coverage from the former carrier to protect against claims made after the expiration date of the former policy.

Prior-acts coverage protects accountants against negligence that occurred before the purchase of the new policy provided that

- ☐ The accountant did not know of the error or omission when the application for the current policy was completed.
- ☐ The claim was reported to the carrier during the policy's effective dates.

**Premiums**
Although the amounts of the policy limit and deductible have the most obvious effect on the cost of malpractice coverage, premiums are also influenced by the number of professional and, under some policies, administrative staff members to be covered.

Some carriers adhere to an equitable premium-computation formula—one that includes in the determination of premiums the firm's claims history, type of services, client base, practice management, and the state(s) in which its practice is located. Under a risk-classification system, those firms involved in engagements that have proved to be less risky and have a favorable claims history are assigned a standard rate and premium that represent their individual risk.

A carrier that spreads risks over its entire risk pool without establishing categories among firms results in the subsidization by low-risk practitioners of the high-risk activities of others. Those firms having a history of claims, engaging in high-risk activity, and accepting high-risk clients may be required to pay a higher premium or deductible for the same amount of coverage provided to other firms with more favorable ratings.

Other factors affecting premiums include the establishment and maintenance of a defensive-accounting program and, again, the state(s) in which the firm practices. States likely to litigate include California, Florida, New York, and Texas.

By becoming aware of those circumstances possibly resulting in a surcharge, which can range from 5 percent to 50 percent of the standard rate, you can more effectively monitor your defensive-practices program.

**Limits**
One of the most difficult insurance-related decisions accountants must make concerns the limits of their

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**Editor:** Graham G. Goddard

## Your Voice in Washington

**Uniform Accountancy Act approved;**
**AICPA Washington office to distribute copies to states**

The boards of directors of the American Institute of Certified Public Accountants and the National Association of State Boards of Accountancy have approved a new uniform accountancy act that will enhance the standards of licensure for CPAs, promote the mobility of CPAs and the services they provide the public, as well as remove the administrative burden of dealing with widely varying regulations of the 54 jurisdictions governing the accounting profession. The act and a plan for implementation are being distributed to state societies.

**Background**

In 1984, the AICPA and NASBA published a joint model accountancy bill in an effort to combine and harmonize separate model bills produced by the two organizations. The process of updating this bill was begun in 1990. An exposure draft of a new uniform act was prepared and distributed to a wide number of constituency groups including state boards of accountancy, state CPA societies, CPA firms, AICPA committees, and individual CPAs. After receiving feedback on the exposure draft, AICPA and NASBA, through the work of committees, finalized a new joint uniform accountancy act.

The Uniform Accountancy Act is drafted as a single comprehensive piece of legislation that could be adopted in place of existing accountancy laws. Because there is an accountancy law in effect in every jurisdiction, however, the act has separable provisions that could be added to existing laws. Designed as a living document, the AICPA and NASBA will publish revisions to the act as often as necessary to address important issues confronting the profession.

**Major provisions**

- ☐ New legal liability sections, providing for proportionate liability, privity, and statute of limitations.
- ☐ One-tier licensing system, which means only a CPA certificate issued and no separate permit to practice.
- ☐ 150-hour education requirement to be completed before applying to take the CPA examination.
- ☐ Mandatory one-year experience requirement for a certificate.
- ☐ Continuing professional education (CPE) requirement for all CPAs.
- ☐ Mandatory quality review for all firms, with a confidentiality provision regarding quality reviews performed by the AICPA or state societies.
- ☐ Interstate and foreign reciprocity sections.

**Uniformity**

With the increasing globalization of capital markets and the need for professional mobility, the demand for uniformity of accountancy licensing requirements has grown measurably. CPAs in firms of all sizes now find a need to practice outside their original licensing jurisdictions.

The 54 jurisdictional accountancy statutes are similar in their framework for certification and licensure. All include an education requirement and require passage of the uniform CPA examination. Most also require experience for licensure and CPE for relicensure. The requirement details vary considerably from state to state, however, and can cause administrative problems for CPAs who wish to relocate and obtain reciprocal licensure.

Uniformity of regulation is a major goal of the AICPA and it is vital that the profession—state societies, state boards, firms, and individual practitioners—work together for passage of uniform accountancy legislation and regulations.

Copies of the act (product no. G00403) are available without charge from the AICPA order department, tel. (800) TO-AICPA. ☑

## Dealing with Audit Fee Resistance

**Letter to the editor**

We are a small, local firm in Southern California that performs a considerable number of certified audits of escrow companies. Because our clients are in a regulated industry, the audits are mandated by the State of California Department of Corporations. We have to follow audit guidelines issued by that agency as well as generally accepted auditing standards.

With the recession still firmly in place (don't let anyone tell you otherwise), we are experiencing more and more fee resistance from our clients. This is understandable because they are really struggling in this economic environment. Real estate is not exactly booming out here in Southern California, these days. The garden spot has sprouted some weeds.

We find it difficult to respond to the clients when they constantly call about our fees. We have them do as much of the clerical work as possible so our staff does not have to do it. Nonetheless, we can only cut back on our own work so much without doing a substandard audit. Having been in the business since 1949, we are in no hurry to make a quick exit by doing an inferior audit.

We would be interested in hearing how other firms and practitioners are dealing with such situations. Perhaps your editorial advisors would care to comment on the subject.

**—Michael C. Haas, CPA,** *Morton Alan Haas & Co., 13720 Riverside Drive, Sherman Oaks, California 91423.*

*Editor's note: Following are comments by Donald B. Scholl, a consultant to CPA firms, who happened by the Institute offices while we were working on this article. We will present some of our editorial advisors' suggestions for dealing with this problem in a subsequent issue of the* Practicing CPA.

**Response**

Firms are using a number of methods to try to keep down auditing fees. Many audit staff make extensive use of laptop and luggable computers with standardized auditing software in order to handle audit functions as efficiently as possible in the field.

Firms also have staff prepare financial statements while out of the office. The idea is to maximize the amount of time staff spend at the client location and to do the engagement as completely as possible before returning to the office.

The outcome of this is that staff is visible to the client, who then becomes better acquainted with the time needed to perform an audit. In addition, the CPA staff work in an environment where they are less likely to be interrupted, thereby enhancing their efficiency in completing the engagement, whereas this might not be the situation back at the office. Partners, also, are going to the client location to perform reviews in process, rather than waiting to receive the entire package after the field work is completed.

Some firms are offering to train the client's personnel to do some of the basic audit functions. They will assist in selecting appropriate software and give on-site instruction in its use.

A suggestion that may offer some opportunities for dealing with the problem is for the partner to spend more time planning the engagement with the in-charge accountant. By this I mean really knowing a client's strengths and weaknesses and organizing assignments so that staff can work efficiently.

All too frequently, staff accountants are sent out with too little guidance and end up spinning their wheels. If adequate time had been allocated to planning and organizing the engagement, and to writing and approving the audit program, staff time in the field could have been substantially reduced. And keep in mind that having the most competent, capable, and experienced people to at least supervise the job, if not in fact perform it, usually results in a more efficient audit. ☑

*—by* **Donald B. Scholl,** *D.B. Scholl, Inc., P.O. Box 3152, West Chester, Pennsylvania 19381*

**Malpractice Insurance** *(Continued from page 2)*

malpractice coverage. By evaluating the following factors, however, you can make an informed coverage decision and choose policy limits that protect your firm's assets and professional interests as well as your continued ability to provide quality services to clients.

- ☐ *Firm size and client base.* A broad client base that includes high-risk clients requires higher limits of coverage.
- ☐ *Claims history (number and severity) and disposition of prior claims.* The fewer serious claims brought against the insured and the more claims dismissed or resolved through nominal settlements, the lower the limits will be.

Policy limits are created on a per-claim/per-occurrence or aggregate basis. A per-claim limit restricts the amount paid for each claim to a specified sum. A per-occurrence limit applies to each incident rather than to each claimant. An aggregate limit is used with both a per-claim and a per-occurrence limit and is the amount the carrier will pay in any one policy year.

The following calculations have been used to measure policy limits.

- ☐ The greater of the total claims asserted or paid during any policy period.
- ☐ The sale price for the firm's largest client.
- ☐ One year's revenues.

It is worth noting that interim increases in policy limits are rarely allowed.

The table, on page 5, provided by Aon Direct Group, Inc., and based on 1990 statistics, does not recommend coverage limits. It does show the percentage of firms purchasing various limits of coverage, however.

**Deductibles and exclusions**

Most accountants' malpractice policies require a deductible, which is the amount of money paid by the insured before the carrier's payment obligations for defense or indemnity are triggered. Deductibles for malpractice policies range from $1,500 to $750,000 for large firms, and under most policies, the deductible applies both to defense costs and indemnity.

You should select a deductible you are confident you can afford. You should also review the policy to make sure you have received a discount on the premium for assuming a sizable deductible.

All professional liability policies carry exclusions for acts outside the scope of coverage for which the accountant is personally liable. An exclusion which is almost universally in accountants' malpractice policies is for claims known to the insured at the effective date of the coverage for which he or she is applying. This prevents the insurance company from insuring losses that have already occurred and are the responsibility of a former carrier.

Exhibit

| | Limits of Liability | | | | | | |
|---|---|---|---|---|---|---|---|
| Staff Size | $250,000 (%) | $500,000 (%) | $1MM (%) | $2MM (%) | $3MM (%) | $4MM (%) | $5MM (%) |
| 1–2 | 51 | 19.8 | 22.2 | 0.89 | 0.5 | 0 | 0.02 |
| 3–4 | 51.8 | 22.5 | 23 | 1.1 | 0.47 | 0 | 0.06 |
| 5–10 | 32.7 | 24.9 | 38.7 | 2.4 | 1.1 | 0 | 0 |
| 11–25 | 0.78 | 23.3 | 66.7 | 6.2 | 2.4 | 0 | 0.5 |
| 26–50 | 0 | 0.2 | 77.1 | 13.2 | 5.9 | 1.2 | 2.3 |
| 51–100 | 0 | 0 | 61 | 21 | 14.4 | 0.9 | 2.7 |
| 101–150 | 0 | 0 | 44 | 24 | 8 | 4 | 20 |
| 151+ | 0 | 0 | 21 | 0 | 43 | 7 | 29 |

A firm can take steps to reduce the likelihood of becoming engaged in activities excluded from its professional liability insurance policy. You can put a provision in your firm's partnership agreement or corporate documents prohibiting firm members from participating in activities excluded by its professional liability insurance policy. Engagements should be monitored to ensure compliance with this rule, and firm agreements updated to maintain consistency with any changes in the policy.

**Obtaining coverage**

Although the overwhelming majority of practitioners, including those with claims histories, are able to obtain malpractice coverage, you should not automatically assume it will be readily available. Begin your search for coverage at least four months before the expiration date of your current policy.

Once the carriers have been identified, obtain specimen policies and compare them against one another and the needs of the firm. Policies vary and subtle differences effect coverage.

A careful review of the policy may reveal that the exclusions section is longer than the description of the coverage. Learn, among other things, which professional services are covered and whether the deductible applies to defense costs.

Discuss any questions concerning the application with the broker. (Insurance premiums entitle actual or potential insurers to the expertise of the carrier's brokers.) Enlist the help of your attorney if necessary. Identifying and resolving questions during the application process will avoid delays occasioned by the return of the application and coverage disputes when a claim is brought.

Answer truthfully and directly all inquiries concerning your firm's claims history. Keep in mind, however, that the complete disclosure requirement of the insurance application process applies as much to information that enhances the firm's image as it does to information that may alert the carrier to a high-risk policyholder. Submit the application to all potential insurers approximately ninety days before the desired effective date of the policy.

Most policy applications ask whether the accountant has been denied insurance in the past. An affirmative response to this inquiry will likely result in higher premiums or a denial of coverage. If it appears that coverage is going to be denied, withdraw the application. Terminating the process at this stage will enable you to state to future carriers that the firm has not previously been denied coverage.

One further point on the subject of obtaining coverage: The carrier offering the lowest premiums may not be the one whose policies best meet the firm's needs or who will be able to defend and indemnify you if a malpractice claim is brought. Choice of carriers should be based not solely on price, but on an objective analysis of all facts pertaining to coverage. It is often best to remain faithful to the carrier offering complete coverage, and service.

**Policy review**

Because professional liability insurance is a top priority for all firms, the policy should be reviewed annually or whenever circumstances warrant. Changes in coverage should be made to reflect changes in firm size and services provided. Policy limits and exclusions, particularly, should be subject to close scrutiny. Policy review should occur at least thirty days prior to the expiration date so changes can be made before the policy's new inception date. ☑

*—by* **Mark F. Murray, J.D.,** *AICPA, New York*

*Editor's Note: Mr. Murray is author of* Managing the Malpractice Maze, *published by the AICPA, from which these comments are excerpted. To purchase the book, product no. 090380, cost $37, call th AICPA order department, (800) TO-AICPA. Ask for operator PC.*

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**Communication**

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**New York, N.Y. 10036-8775**

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